NASBIC
America's Small Business Partners

Statement of Lee W. Mercer President

National Association of Small Business Investment Companies

Submitted To The

United States Senate Committee on Small Business and Entrepreneurship

February 27, 2002

National Association of Small Business Investment Companies
666 11th Street • N.W. • Suite 750 • Washington, • DC 20001
Tel: 202.628.5055 • Fax 202.628.5080
www.nasbic.org
E-mail: nasbic@nasbic.org

Chairman Kerry, Senator Bond, members of the Committee:

On behalf of the National Association of Small Business Investment Companies, I appreciate the opportunity to submit testimony today concerning the Administration's FY 2003 SBIC program budget proposal. I am pleased to report that the budget has the unqualified support of the SBIC industry. We urge the Committee to support the SBIC budget proposal as submitted.

The budget calls for the availability of $4 billion in Participating Security leverage and $3 billion in Debenture leverage. As is the case this year, FY 2003 leverage would be supported 100% by fees and interest paid to the government by Debenture SBICs and by fees, prioritized payments, and profit distributions paid to the government by Participating Security SBICs. The per annum portion of those costs will be virtually unchanged from the FY 2002 rates. Thus, as is the case this year, no appropriation will be required to make $7 billion available. When added to the minimum required private capital, $10 billion in new capital will be made available for SBIC investments in U.S. small businesses.

At a time when the U.S. economy can use all the financial help it can get, SBICs are proving their value as steady and reliable sources of venture capital for America's small business entrepreneurs. For the fiscal year ended September 30, 2001, SBICs invested $4.6 billion in 2,254 companies. Although the total invested was down 18% from the record $5.5 billion of FY 2000, it was 7% more than the $4.2 billion invested in FY 1999, with 14% more companies receiving financing than in FY'99. Of great importance to small businesses seeking capital, SBICs are proving to be a far more stable source of financing than non-SBIC venture capital funds. According to Venture Economics and the National Venture Capital Association, for the same fiscal 2001 period, all venture capital investments totaled $52.3 billion, down 51% from $106.1 billion the total invested in the same fiscal 2000 period. Calendar-year statistics are even more revealing. All venture capital investments dropped from $99.6 billion in 2000 to $36.6 billion in 2001—a 63% drop. SBIC investments dropped just 3% for the same period.

SBICs continued to be a significant source of capital for new businesses, with 58% of all FY 2001 investments made in companies in business for three years or less. The average size of investments by all SBICs continued at the $1 million mark while non-SBIC investments averaged $11 million for the same period. For leveraged SBICs, the average and median investment sizes were well below the $1 million level. These numbers speak to the importance of SBIC capital to the great numbers of younger, smaller, less capital-intensive companies that become important parts of the economic foundations of their respective communities. In this regard, it is interesting to note that almost $1 billion, 22% of total investments, were made in companies located in Low- and Moderate-Income areas as defined by the government. I have attached a sheet containing some of the relevant FY 2001 SBIC investment statistics to further underscore that SBICs are producing the results that Congress intended when its redesign of the program became effective in FY 1994. We are pleased to note that the Administration has also recognized the effectiveness of the SBIC program in its rating of SBA programs for budget allocation purposes.

Total SBIC capital resources rose from $15.4 billion at year-end FY 2000 to $18.8 billion at the close of FY'01—an increase of 22%. Further, despite the fact that raising venture capital is substantially more difficult at present, the SBIC program continues to grow. Private investors committed $1.1 billion in new private capital to the 51 new SBICs licensed in FY 2001, down 9% from FY 2000, but 47% more than the $747 million committed in FY 1999. The backlog of current license applications at SBA and the rate at which new applications are being received make it likely that a similar number of new funds will be licensed this year. This will ensure the continued flow of critical venture capital to the fast growing U.S. small businesses that are the foundation of U.S. job creation and economic growth.

With the jarring economic contraction we have experienced over the past 18 months or so, some losses in the SBIC program are to be expected. Economic business cycles apply to SBICs just as they do to all other business endeavors. However, the SBIC program remains strong. The SBIC program is designed to stimulate the flow of scarce venture capital to U.S. small businesses in such a way that over time the government neither makes money nor loses money in connection with the augmentation of private capital by government-guaranteed capital. Using a complex model, the Office of Management and Budget (OMB) sets the "reserves" that must be established each year to meet potential out-year losses associated with the projected failure by some SBICs to repay some or all of their leverage. While there is no "lock box" for the annual reserve amounts, they are made up of fees, interest, prioritized returns, and profit shares paid directly to the government by SBICs and, when required, annual appropriations agreed to by Congress. The balance of these "reserves" for the period FY'94–FY'01 was approximately $500 million at the close of FY'01. Since the private capital of each fund is at risk before government-guaranteed capital, the practical reserves are even greater, and more funds are being added to reserves in FY'02. The program is in a strong position to weather the current economic cycle over time and will all the while continue to be a constant source of venture capital for starting and expanding U.S. small businesses.

Suggested Legislation

We ask your continued support for legislation that would exempt income received by tax-exempt institutional investors from Debenture SBICs they might invest in from treatment as Unrelated Business Taxable Income (UBTI) under the Internal Revenue Code (IRC). These investors include pension funds, charitable foundations, and university endowment funds. UBTI is subject to filing requirements and taxation and creates a strong, almost total, disincentive for tax-exempt investors that might otherwise be interested in investing in one or more Debenture funds. The exemption would provide Debenture SBICs with access to substantial sources of potential private capital that are not available to them at present, capital sources that <u>are</u> available to Participating Security SBICs and other equity based venture capital funds. We note with appreciation the fact that Democrats and Republicans cleared the proposed amendment during debate on the recently considered but not passed economic stimulus bill. We hope there will be another bill this year that serves as the vehicle for passage of the amendment.

UBTI is created automatically by Debenture SBICs because government guaranteed capital used to augment private capital in the Debenture program is borrowed capital. It is structured that way by the provisions of the Small Business Investment Act. The IRC treats the borrowed capital as "acquisition indebtedness," indebtedness that triggers UBTI. This is unlike the Participating Security program wherein the government-guaranteed capital is structured as an equity investment by the government in the SBICs receiving the same.

UBTI treatment makes it virtually impossible for Debenture SBICs to raise private capital from tax-exempt institutional investors. The reason is not that tax-exempt institutional investors do not invest in venture capital funds. They do. According to Thomson Financial / Venture Economics of Newark, New Jersey, institutional investors provide as much as 60% of the capital invested in venture capital funds each year. However, given the option of investing in venture capital funds that create UBTI and those that do not, it is not surprising to learn that tax-exempt investors almost always opt to invest in the latter category of funds. Investments in equity-based funds do not create UBTI for tax-exempt investors.

The disincentives of UBTI tax rules have no place in the context of fundraising for the SBIC program. The express congressional policy of the Small Business Investment Act is: "to improve and stimulate the national economy in general and the small business segment thereof in particular by establishing a program to stimulate and supplement the flow of private equity capital and <u>long-term loans</u> which small-business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization … <u>provided, however, that this policy shall be carried out in such a manner as to insure the maximum participation of private financing sources</u>." *Section 102 of the Act, emphasis added. Private capital held by tax*-exempt organizations represents the large majority of private capital potentially available to SBICs for investing in domestic small businesses. To advance the express policy of the Small Business Investment Act, it is reasonable that Congress exclude from the definition of UBTI any income received by a tax-exempt organization that is derived from an investment in an SBIC.

The Debenture SBIC program was designed to enable Debenture SBICs to make loans to small businesses that are generally subordinate to, and may be the basis for, more senior credit facilities from commercial banks. As such, these subordinated loans are often critical to the survival of the small businesses that secure them. Such loans are particularly suited for family-owned businesses that may never reach the growth required to "go public," or, for companies whose owners may never want to give up equity in (or control of) their companies by the sale of large blocks of stock. These companies are often found in the heartland of America, not the "hot" locations that typically attract media attention. Nonetheless, these companies are important to America's economic wellbeing in general and the health of their local communities in particular. They are often primary employers in the areas in which they are located.

There will be little or no tax revenue loss if an exemption from UBTI consequences is provided for tax-exempt institutional investors investing in Debenture SBICs. At year-end FY 2001, we estimate that less than $35 million in tax-exempt investor funds were invested in Debenture SBICs - only 2% of the $1.6 billion in private capital invested in all Debenture funds. We estimate the revenue impact will be no more than $1 million per year. We have strong support in the Senate for the proposed change. We hope that, following your consideration of the issues involved, the Committee will support the proposed change as well and work with the Ways and Means Committee to see it included in an appropriate piece of legislation. Adopting the change is the single most effective step Congress could take this year to increase private capital investment in Debenture SBICs and, therefore, in the small businesses they serve.

Thank you again for your consideration our views. We look forward to working with you again this year to further improve the SBIC program and its ability serve America's small businesses.

NASBIC

America's Small Business Partners

Small Business Investment Company Program Statistics

Fiscal Year 2001 SBIC Data From SBA Reports

Investments By Type Of SBIC	**Number**	**Total $ Amount**	**$ %**	**$ Average**	**$ Median**
Participating Security SBICs	1,879	1,443,486,832	32%	768,221	300,000
Debenture SBICs	1,256	694,087,131	16%	552,617	163,161
Bank SBICs (No Leverage)	832	2,272,926,251	51%	2,731,883	1,064,275
Specialized SBICs	310	44,774,829	1%	144,435	50,000
Total Investments	**4,277**	**4,455,275,043**	**100%**	**1,041,682**	**257,500**
Category Of Investments					
Straight Debt	1,066	289,633,931	7%	271,702	78,133
Debt With Equity Features	1,349	903,422,529	20%	669,698	225,000
Equity Only	1862	3,262,218,583	73%	1,751,997	796,127
Total Investments	**4,277**	**4,455,275,043**	**100%**	**1,041,682**	**257,500**
Investments By Business Age					
Under 3 Years	2,285	2,568,339,023	58%	1,124,000	250,000
3 to 6 Years	924	969,993,147	22%	1,049,776	334,056
6 to 10 Years	436	285,358,160	6%	654,491	249,498
Over 10 Years	632	631,584,713	14%	999,343	267,337
Total Investments	**4,277**	**4,455,275,043**	**100%**	**1,041,682**	**257,500**
Investments By Business Type					
High Technology Businesses	1,664	1,916,853,818	43%	1,151,955	400,500
All Other Businesses	2,613	2,538,421,225	57%	971,459	210,000
Total Investments	**4,277**	**4,455,275,043**	**100%**	**1,041,682**	**257,500**
Investments In LMI Areas					
Low-Income Areas	633	562,146,200	13%	888,067	160,000
Moderate-Income Areas	487	425,416,973	10%	873,546	200,000
Total LMI Investments	**1,120**	**987,563,173**	**23%**	**881,753**	**186,463**

Notes:

1. A total of 2,254 small businesses received SBIC financing from 4,277 investments made in FY 2001.
2. The median number of employees in SBIC-financed companies in FY 2001 was 30.
3. The average non-SBIC venture capital investment equaled approximately $11 million in 2001.
4. Approximately 85% of all non-SBIC venture capital investments are made in high-technology firms.
5. Participating Security SBICs had distributed $279 million in profits to SBA through February 6, 2002.
6. SBIC investments were 55% of transactions and 12% of total dollars for January-September 2001.

National Association of Small Business Investment Companies
666 11th Street, N.W. • Suite 750 • Washington, DC 20001
Tel: 202-628-5055 • Fax: 202-628-5080
Internet: www.nasbic.org • E-Mail: nasbic@nasbic.org